United States Court of Appeals

for the Second Circuit

APPELLEE'S BRIEF

ORIGINAL

75-7256

B P/S

United States Court of Appeals

For the Second Circuit

S. WILLIAM GREEN, EVELYN GREEN and CYNTHIA COLIN, as Executors of the Estate of LOUIS A. GREEN, deceased, and EVELYN GREEN, individually, and as stockholders of Kirby Lumber Corporation, suing on behalf of themselves and for the benefit of said corporation and for the class of all other stockholders of said corporation similarly situated,

Plaintiffs-Appellants,

against

SANTA FE INDUSTRIES, INC., SANTA FE NATURAL RESOURCES, INC., KIRBY LUMBER CORPORATION, and MORGAN STANLEY & CO.,

Defendants-Appellees.

Appeal from the United States District Court for the Southern District of New York

BRIEF FOR DEFENDANTS-APPELLEES

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2

TABLE OF CONTENTS

AUTHORITIES CITED

Cases:

Statutes:

Other authorities:

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

- x

S. WILLIAM GREEN, EVELYN GREEN and CYNTHIA COLIN, as Executors of the Estate of LOUIS A. GREEN, deceased, and EVELYN GREEN, individually, and as stockholders of KIRBY LUMBER CORPORATION, suing on behalf of themselves and for the benefit of said corporation and for the class of all other stockholders of said corporation similarly situated,

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Defendants-Appellees.

- x

QUESTIONS PRESENTED

1. Did the District Court correctly hold that an action by minority shareholders of a Delaware corporation, for alleged undervaluation of their stock in connection with a short-form merger under Section 253 of the Delaware General Corporation Law, failed to state a claim under Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5, where no allegation was made of any misrepresentation or nondisclosure?

2. Did the District Court correctly hold that no claim under the federal securities laws arose

from the fact that notice of a Delaware short-form merger was sent to minority shareholders after, rather than before, the merger was effected, where (a) the applicable Delaware statute expressly provides that notice shall be sent after the merger, and (b) it was undisputed that all material facts were fully disclosed to the minority shareholders, before they were obliged to decide between accepting the price tendered or seeking appraisal of their shares as permitted by the Delaware statute?

3. Did the District Court correctly hold that the amended complaint failed to state a claim under Delaware state law, with respect to the Delaware short-form merger described above, where the Delaware courts have held that equitable relief is not available to minority shareholders in a short-form merger, and that the exclusive remedy under state law is an action for appraisal, as provided by the Delaware statute?

4. Did the District Court correctly dismiss the purported derivative claim on behalf of Kirby Lumber Corporation on the grounds that (a) plaintiffs, no longer being shareholders of that corporation, do not have standing to maintain a derivative action, and (b) the derivative recovery would in any event be an inappropriate remedy, since the corporation is now a wholly-owned subsidiary of one of the defendants?

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

- x

S. WILLIAM GREEN, EVELYN GREEN and CYNTHIA COLIN, as Executors of the Estate of LOUIS A. GREEN, deceased, and EVELYN GREEN, individually, and as stockholders of KIRBY LUMBER CORPORATION, suing on behalf of themselves and for the benefit of said corporation and for the class of all other stockholders of said corporation similarly situated,

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- x

BRIEF FOR DEFENDANTS-APPELLEES

Preliminary Statement

This action was brought under § 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder, and under state law. The gravamen of the amended complaint is that the defendants Santa Fe Industries, Inc., Santa Fe Natural Resources, Inc., and Kirby Lumber Corporation, in violation of the above statute and rule, caused a Delaware corporation to engage in a short-form merger which allegedly gave the minority shareholders a substantially undervalued

price for their stock, and that defendant Morgan Stanley & Co. allegedly gave a false opinion as to the fair market value of the stock. There is not present in this action any allegation of deception, misrepresentation, or nondisclosure: on the contrary, plaintiffs concede that the factual allegations of the complaint are entirely drawn from the detailed disclosures that were made to the minority shareholders. Plaintiffs have not specified any fraud or deception in the events that occurred before, during or after the merger.

Rather, plaintiffs' entire claim consists of allegations that (1) there was no announcement of the pending merger prior to its occurrence, and (2) the price offered the minority shareholders was inadequate (see Pl. Br. pp. 14, 31.)* But, singly or together, these allegations do not constitute fraud under any conceivable reading of Rule 10b-5. As further set forth below, the Delaware merger statute not only does not require notice prior to the event, but affirmatively indicates that notice shall be sent thereafter. The Delaware statute permits dissatisfied minority shareholders to maintain an appraisal action if dissatisfied with the price. Even assuming arguendo (as did

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* Citations to "(Pl. Br.)" are to the brief for plaintiffs-appellants.

the District Court), for the purposes of this motion, the correctness of the allegations as to the undervaluation, plaintiffs' appraisal claim does not state a federal claim under the securities laws.

Statement of the Case

Plaintiffs concede (Pl. Br. p.4) the absence of any dispute as to the facts on which the decision below was based. Divested of the rhetoric and conclusory charges contained in plaintiffs' statement of the case, the material facts are simple, and show clearly the absence of any genuine claim under Rule 10b-5.

Plaintiffs herein were minority shareholders of Kirby Lumber Corporation ("Kirby"), a Delaware corporation (72A)* engaging in the manufacture of plywood, lumber and related products and owning various timber and mineral resources in Texas and Louisiana (37A-40A). For some years prior to the transactions here involved, approximately 95% of the capital stock of Kirby was owned by defendant Santa Fe Natural Resources, Inc. ("Resources"), which in turn is a wholly-owned subsidiary of defendant Santa Fe

* Citations to "(A)" are to the Appendix on this appeal.

Industries, Inc. ("Santa Fe"), the parent company of the Atchison, Topeka and Santa Fe Railway Company (26A). In 1974 Resources exercised its right to effect a short-form merger pursuant to Section 253 of the Delaware General Corporation Law (12A-13A). That law permits a parent corporation owning at least 90% of the capital stock of a subsidiary to merge the parent and subsidiary, upon approval by the parent's board of directors and stockholders. A resolution of merger under Section 253 may provide that all shares held by minority stockholders will be purchased for cash; by the terms of the statute, consent of the minority stockholders is not required. Any minority shareholder who is dissatisfied with the cash valuation of his shares is permitted, in the event agreement with the corporation cannot be reached, to commence an action for appraisal in the Delaware Court of Chancery. Delaware General Corporation Law, §§ 253, 262 (50A-55A).

To implement the short-form merger, Forest Products Inc. ("FPI") was organized in July 1974 as a Delaware corporation. Shortly thereafter, Resources transferred to FPI approximately 95% of the capital stock of Kirby, together with cash and the assumption of certain liabilities, in exchange for all of FPI's capital stock. FPI, a wholly-owned subsidiary of

Resources, thus became the 95% owner of Kirby. Thereafter, the board of FPI adopted a resolution of merger pursuant to Section 253 of the Delaware Corporation Law, providing that FPI would be merged into Kirby, with Kirby as the surviving corporation. The resolution provided that the shareholders of Kirby other than FPI would have the right to receive $150 per share in cash or to seek appraisal for their stock, as permitted by the Delaware statute. The steps necessary to effect the merger under the Delaware statute were completed and the merger became effective on July 31, 1974 (18A).

The Delaware statute requires (Del. Corp. L. § 253(b)) that, following such a short-form merger, "the surviving corporation shall, within 10 days after the effective date of the merger, notify each stockholder of such Delaware corporation that the merger has become effective." In compliance with this provision, on August 1, 1974, the minority shareholders of Kirby were notified of the merger and advised that they had the right here to receive $150 per share in cash or to seek appraisal for such shares under the applicable Delaware statute (12A-13A).

A lengthy and detailed information statement regarding Kirby was sent with the notice to the minority shareholders (14A-71A). Plaintiffs herein

have not alleged any misrepresentation or nondisclosure in that information statement; on the contrary, the factual allegations of the amended complaint are based entirely upon the disclosures contained therein (see Amended Complaint, Paras. 7, 9, 75A, 76A). The statements sent to minority shareholders contained substantial financial data about Kirby as well as:

1. an opinion by defendant Morgan Stanley & Co. ("Morgan Stanley") that the fair market value of the Kirby stock was $125 per share based on the assumptions that "(i) the shares of Kirby were broadly distributed and freely traded such that willing buyers and willing sellers could readily effect transactions and (ii) the shares were split so that they would trade within the range of prices typical for many publicly-held companies" (60A-61A);

2. an appraisal of Kirby's land, timber, buildings and machinery conducted by Appraisal Associates of Kansas City, Missouri (Resources Management Services, Inc., a firm of professional foresters, assisted Appraisal Associates by preparing an updated inventory of the Kirby forests) (62A-63A); and

3. an appraisal of Kirby's oil and gas royalty interests and Kirby's ownership in mineral properties by Riggs and Associates, a

firm of petroleum reservoir consultants (64A-66A).

All of the factual data upon which plaintiffs base their charges of undervaluation were fully set forth in the information statement. The figures as to the asset value of Kirby, upon which plaintiffs rely, are taken from the same information statement. Plaintiffs do not dispute that all of the material facts relating to this transaction were made available to all minority shareholders of Kirby, prior to the time when the shareholders had to decide whether to accept the $150 per share, or press their claim for an appraisal pursuant to Delaware law.

None of the plaintiffs has tendered any of the stock of Kirby Lumber Corporation. On August 21, 1974 the plaintiffs made a demand for appraisal of their Kirby stock. On September 9, 1974 they purported to withdraw their demand for a statutory appraisal. Both of these events antedated the filing of the lawsuit on September 10, 1974 (11A).

The Pleadings

The essence of plaintiffs' original complaint (2A-9A) was that the short-form merger allegedly resulted in the acquisition of the minority shares at a "grossly undervalued price" (Para. 9, 5A), and that this constituted a "manipulative and deceptive device

in breach of SEC Rule 10b-5 and a breach of fiduciary obligation owed to Kirby and its minority stockholders." After defendants moved to dismiss, plaintiffs served an amended complaint (72A-78A), pleading that the merger was accomplished "without prior notice" (Para. 5, 73A). The amended complaint cited (Para. 7, 75A) an opinion from Appraisal Associates which placed the value of Kirby's land and timber at $320 million. Relying upon this figure from the information statement, which had been furnished to them and other minority shareholders by the Santa Fe defendants, plaintiffs alleged that the appraisal of the minority shares should have been at least equal to the claimed liquidation value of $772 per share (Para. 7, 75A). Plaintiffs further alleged, in conclusory terms, that Morgan Stanley "knew the pro rata value of the physical assets of Kirby was at least $772 per share" (Para. 9, 76A).

In addition to alleging that the merger was not announced in advance, and that the price offered to minority shareholders undervalued the stock, the pleadings contained other conclusory

charges of "fraud", a "device, scheme or artifice to defraud" and the like; the motion to dismiss was coupled with a motion under Rule 9(b) to compel plaintiffs to state what if any specific allegations were intended by these conclusory terms. Plaintiffs have now stated that no misrepresentation is alleged, and that the only "fraud" asserted consists of the lack of advance notice of the merger, and the claimed undervaluation of the stock (see Pl. Br. pp. 14, 31).

ARGUMENT

The District Court Correctly Held That Plaintiffs Failed to State a Claim Under Rule 10b-5

Plaintiffs have thus set forth what is, in substance, simply a claim for alleged undervaluation of their shares in connection with a Delaware short-form merger.* Assuming, for the purposes of this

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* In the court below, plaintiffs also contended that the Delaware short-form merger would violate Rule 10b-5 unless there was a valid "corporate purpose" for the same, citing Bryan v. Brock & Blevins Co., 490 F.2d 563 (5th Cir. 1974), cert. denied, 419 U.S. 844. On appeal, plaintiffs appear -- although this is not entirely clear -- to have abandoned this position (see Pl. Br. pp. 32-33). The contention would in any event be untenable. Bryan was decided by the Fifth Circuit, not under Rule 10b-5, but under the state law of Georgia, and the law of Delaware on this point is clearly to the contrary. The Delaware courts have held that "the very purpose of the statute [Del. Corp. L. § 253] is to provide the parent corporation with a means of eliminating the minority

(Footnote continued next page)

motion, the correctness of plaintiffs' allegations as to valuation, plaintiffs would have a meritorious appraisal action in the state courts under the applicable Delaware statute. They cannot, however, convert a state law cause of action for appraisal into a federal claim under the securities laws merely by invoking, in conclusory terms, the language of Rule 10b-5.

Plaintiffs expressly disclaimed any allegation of misrepresentation (Pl. Br. p. 37), and they do not dispute that all of the material facts as to valuation of the stock were fully disclosed to minority shareholders on August 1, 1974, well before the shareholders had to decide to accept the offer or to seek appraisal (13A). Under these circumstances, the purported claim under Rule 10b-5 is clearly insufficient.

(Footnote continued from previous page)

shareholder's interest in the enterprise". Stauffer v. Standard Brands Inc., 41 Del. Ch. 7, 187 A.2d 78 (Del. Sup.Ct. 1962). Accordingly, under Delaware law, "the reasons for a merger or the business necessity behind it are not matters for judicial determination". Bruce v. E. L. Bruce Company, 40 Del. Ch. 80, 174 A.2d 29, 30 (Del. Ch. 1961). See, also, Application of Delaware Racing Ass'n, 42 Del. Ch. 406, 213 A.2d 203, 209 (Del. Sup.Ct. 1965); Braasch v. Goldschmidt, 41 Del. Ch. 519, 199 A.2d 760 (Del. Ch. 1964). Similarly, the alleged absence of a corporate purpose "is, for federal purposes at least, a matter of no consequence". Tanzer Economic Associates v. Haynie, 388 F.Supp. 365, 369 (S.D.N.Y. 1974).

It is well settled that Section 10(b) and Rule 10b-5 are essentially disclosure provisions, designed to insure accurate information as to transactions within their scope, and not to regulate the merits of such transactions. Rule 10b-5, in this respect, is related to the common law tort of misrepresentation and deceit. Blue Chip Stamps v. Manor Drug Stores, U.S. , 95 S.Ct. 1917, 1929 (1975). As this Court held in Popkin v. Bishop, 464 F.2d 714, 719-720 (1972), "Section 10(b) of the Exchange Act and Rule 10b-5 are designed principally to impose a duty to disclose and inform rather than to become enmeshed in passing judgements on information elicited."

In Popkin, an action under Rule 10b-5 was brought on the basis of a proxy statement, which was issued in connection with the merger of three Delaware corporations. There, as in the present action, plaintiffs contended that the exchange ratios incorporated in the merger agreement were "grossly inadequate". The factual basis for this contention was information submitted to the plaintiffs and others in the proxy statement issued by defendants.

Under these circumstances the Court of Appeals held that the plaintiffs' action had been

properly dismissed by the District Court because it did not state a cause of action for violation of Rule 10b-5. Noting first that "we are willing to assume that [plaintiffs are] correct and that the exchange ratios are unfair", the Court went on to point out that there were no allegations in the complaint of misrepresentation or failure to disclose by the defendants. Furthermore, the Court stated (p. 718):

> "More significantly, in the district court, although appellant pointed to one alleged material omission, he was 'willing to assume, arguendo, for the purpose of this motion only, that the Proxy Statement made a full and fair disclosure.' Both in the district court and on appeal, appellant has relied heavily--almost exclusively--on the actual contents of the Proxy Statement in his attempt to demonstrate the unfairness of the merger proposal. Thus, the record before us hardly presents a picture of deception or nondisclosure, ordinarily alleged in private actions under Rule 10b-5." [Emphasis in original] [Footnote omitted]

Defendants submit that the Popkin decision is squarely applicable here. Plaintiffs are in the anomalous position of attempting to bring a nondisclosure action, based upon facts which were disclosed to them by defendants. Whatever the merits of a possible appraisal action under state law, plaintiffs' allegations as to the alleged undervaluation "simply do not state a federal claim." Greenberg v. Institutional Investor Systems, Inc., [Current] CCH Fed. Sec. L. Rep.

¶ 95, 231 (S.D.N.Y. 1975) (not yet officially reported), at p. 98, 231.

The holding in Popkin was followed and applied in Dreier v. The Music Makers Group, Inc., F.Supp. 1973-74 CCH Fed. Sec. L. Rep. ¶ 94,406 (S.D.N.Y. 1974) (not yet officially reported). In Dreier, the individual defendants owned all of the stock of the corporate defendant Leigh Group, Inc., which in turn owned a majority stock interest in Music Makers Group. Leigh Group and Music Makers Group were merged under a plan which eliminated the minority shareholders of Music Makers Group, who were to receive $3.00 per share for their common stock. Plaintiffs alleged, among other things, that the price for the minority shares represented a gross undervaluation, and that the merger therefore constituted a fraud under Rule 10b-5. In dismissing the complaint with respect to this claim, Judge Gagliardi held 1973-74 CCH Fed. Sec. L. Rep. at p. 95,410:

> "Turning to the allegations with regard to the merger of Music Makers into Leigh Group, I find that the complaint fails to state a cause of action under the federal securities laws. Recognizing the validity of plaintiff's contention that defendants' ability to effectuate the merger without minority support does not insulate the transaction from an attack under section 10(b) and Rule 10b-5 [Vine v. Beneficial Finance Co., 374 F.2d 627 (2d Cir.) cert. denied, 389 U.S. 970 (1967)] and that plaintiff has standing as a 'forced seller', this

court cannot overlook the absence of any allegation of misrepresentation or nondisclosure in connection with the merger. The complaint alleges that the individual defendants effectuated the merger merely to derive a personal financial gain and that the terms of the merger requiring minority shareholders to sell at a price of three dollars per share were grossly unfair. Accepting the truth of these allegations, I find that the complaint fails to state a cause of action under the federal securities laws arising out of the merger transaction. Beyond cavil, the scope of section 10(b) and Rule 10b-5 extends to transactions of this type. [Citations omitted] [H]owever, nondisclosure remains an essential element in any section 10(b)-Rule 10b-5 action. Popkin v. Bishop, 446 F.2d 714 (2d Cir. 1972). The instant complaint does not allege any nondisclosure in connection with the merger; the treatment of the minority shareholders may well have been grossly unfair but it was completely open. Under these circumstances plaintiff's remedy is a state court action for appraisal pursuant to the Delaware Corporation Law." [Emphasis supplied]

A similar result was reached in Tanzer Economic Associates, Inc. v. Haynie, 388 F.Supp. 365 (S.D.N.Y. 1974), another case in which plaintiffs based a charge of undervaluation upon information which the defendants had disclosed. After an extensive review of the applicable authorities, Judge Frankel held (388 F.Supp. at p. 369):

"It is claimed that the proxy statement should have set out a net current asset value of about $35 per share, a figure plaintiff derives from the material that was given. [Emphasis in original]. The court

> does not find basis for saying that this aspect of the complaint shows a material omission or omissions. Whatever it tells about the fair price per share, the net asset value was discernible, as plaintiff discerned it. True, plaintiff has expertise at its disposal beyond that possessed by the average shareholder. But the expertise has served here only to frame a debate, not to show a 'misstatement.'" [Emphasis supplied]

In attempting to argue (Pl. Br. p. 12) that misrepresentation and nondisclosure are not required, plaintiffs rely heavily upon a carefully selected quotation from Levine v. Biddle Sawyer Corp., 383 F.Supp. 618 (S.D.N.Y. 1974), which they cite for the proposition that advance notice of the merger was required. However, the portions of the opinion not quoted by plaintiffs show that that case involved numerous and specific allegations of misrepresentation, deceit and concealment. Thus, the court in Levine stated (p. 622):

> "Unlike the complaints in Popkin v. Bishop, 464 F.2d 714 (2d Cir. 1972) and Dreier v. The Music Makers Group, Inc. [1973-1974 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 94,406 (S.D.N.Y. 1974), the complaint here is replete with allegations of misrepresentation and nondisclosure in connection with the merger."

In detailing the allegations of the fraud there involved, the court recited (ibid.):

> "Involved in the alleged scheme, according to the amended complaint,

were misrepresentations to plaintiffs as to the true value of their stock, concealment of facts from and deception of plaintiffs, particularly Robert Levine, and misrepresentation and nondisclosure of relevant financial information to the Moseley firm, which was retained to evaluate Biddle for the purpose of deciding how much to offer plaintiffs upon surrender of their shares in a Delaware short form merger."

Plaintiffs are also incorrect in citing Schlick v. Penn-Dixie Cement Corp., 507 F.2d 374 (2d Cir. 1974), cert. denied, U.S. , 95 S.Ct. 1976 (1975), for the proposition (Pl. Br. pp. 28-29, 34-35) that they are not required to plead specific misrepresentations or nondisclosures. The Court in Schlick first reaffirmed the principle that a valid claim under Rule 10b-5 cannot be stated by conclusory allegations of "fraud", citing Segal v. Gordon, 467 F.2d 602, 607 (2d Cir. 1972), and Shemtob v. Shearson, Hammill & Co., 448 F.2d 442 (2d Cir. 1971) and then proceeded to hold that the complaint there sufficiently pleaded "a specific scheme to defraud" (pp. 378-9). As the Court there noted, the complaint in Schlick charged numerous specific deceptions as to accounting practices (ibid.):

"The complaint alleges the charging of excessive intercompany costs to Continental, thus reducing Continental's income and increasing that of Penn-Dixie. It alleges an

> accounting change, valuing certain Continental inventories on a last-in, first-out basis rather than average cost as had been done prior to 1971, thereby incurring a $595,000 special income charge reducing Continental's earnings for the year ending December 31, 1972, the year prior to merger. The complaint also alleges an over-inflation of Penn-Dixie assets by including in Penn-Dixie book value the sum of $21,425,000 which was the excess of cost over related net assets attributed to Penn-Dixie's purchase of the common stock of Continental. Finally, it alleges that the appellees caused the Continental pension fund to purchase common stock of Penn-Dixie on the market in order to create a higher price for the shares of Penn-Dixie, which higher price was utilized to obtain an exchange ratio more favorable to Penn-Dixie." [Footnote omitted]

Shortly after the decision in Schlick, Judge Frankel -- who sat by designation on the panel in that case -- expressly reaffirmed the insufficiency, under Rule 10b-5, of an undervaluation claim similar to that alleged here. See Tanzer Economic Associates, Inc. v. Haynie, 388 F.Supp. 365 (S.D.N.Y. 1974), supra.

Plaintiffs also rely heavily (Pl. Br. pp. 11, 22, 37) on two sentences extracted from the opinion of this Court in Competitive Associates, Inc. v. Laventhol, Krekstein, Horwath & Horwath,

[Current] CCH Fed. Sec. L. Rep. ¶ 95,090 (2d Cir. 5/8/75) (not yet officially reported). In Competitive Associates, this Court rejected the defendants' argument that a showing of reliance should be required because the "nondisclosures" alleged by plaintiffs were actually "misrepresentations". The Court did not, however, hold that a claim can be stated under Rule 10b-5 without any allegation of either misrepresentation or nondisclosure. On the contrary, an examination of the context from which plaintiffs select their quotation shows that their reliance on Competitive Associates is misplaced, and also that they have misconstrued the holding in Schlick (p. 97,866):

> "However, as this court made quite clear in the Schlick case in which the district court's dismissal of plaintiff's complaint was reversed, a showing of reliance is not required where a comprehensive scheme to defraud which includes not only omissions and misrepresentation, but substantial collateral conduct as well, is alleged. ¶ 94,853 at 96,876. Not every violation of the anti-fraud provisions of the federal securities law can be, or should be, forced into a category

> headed 'misrepresentations' or 'nondisclosures'. Fraudulent devices, practices, schemes, artifices and courses of business are also interdicted by the securities laws. In the case before us, plaintiff has charged the accounting defendants not only with affirmative misrepresentations in the financial statements, but also with a failure to disclose the true financial condition of Takara Partners and the alleged receipt of payoffs in return for its certification; furthermore, both misrepresentations and omissions are alleged to be only one aspect of an elaborate scheme to defraud." [Emphasis supplied]

The other cases cited by plaintiffs actually serve to confirm the indispensability, to a claim under Rule 10b-5, of a specific fraud or nondisclosure Thus, for example, Schoenbaum v. Firstbrook, 405 F.2d 215 (2d Cir. 1968), *cert. denied*, 395 U.S. 906 (Pl. Br. pp. 8-10, 20, 22, 28), was an insider trading case: Plaintiffs in Schoenbaum alleged that the defendant directors had offered treasury stock to the controlling shareholder at the then prevailing market price, with knowledge of a major oil discovery which had not yet been publicly disclosed (405 F.2d at 217-8). In the present case, as noted above, it is

not disputed that the facts as to Kirby's assets were fully disclosed to the shareholders before they were called upon to decide between acceptance and appraisal. In A. T. Brod & Co. v. Perlow, 375 F.2d 393 (2d Cir. 1967), cited at Pl. Br. pp. 29-30, it was alleged that the defendants had entered into a fraudulent scheme of placing purchase orders with various brokers and dealers, with the undisclosed intention of paying only for securities which had appreciated by the payment date, and of refusing to honor purchases for securities which had declined (375 F.2d at 395). In Swanson v. American Consumer Industries, Inc., 415 F.2d 1326 (7th Cir. 1969) (Pl. Br. p.23), the directors of a corporation recommended approval of a sale of the corporation's assets, without disclosing (inter alia) that they were also officers and directors of the prospective purchaser. 415 F.2d at p. 1330.

Pappas v. Moss, 393 F.2d 865 (3rd Cir. 1968) (Pl. Br. pp. 8, 12-13) was a derivative suit against directors who had purchased stock of their corporation on favorable terms; shareholder ratification of the purchase had been obtained through materials which contained "at least two material misrepresentations of fact" (393 F.2d at p. 869). Shell v. Hensley, 430 F.2d 819 (5th Cir. 1970) (Pl. Br. 8, 13) was a

derivative suit against officers who had conspired to divert corporate funds to their personal use; among the specific deceptions alleged were nondisclosures as to the value of securities and land sold to the corporation, and a sham employment contract intended to conceal improper payments to one of the defendants (430 F.2d at p. 825). In Voege v. American Sumatra Tobacco Corporation, 241 F.Supp. 369 (D. Del. 1965), cited at Pl. Br. pp. 8, 12, the material information withheld by defendants in connection with the exchange offer included the facts that defendants intended to liquidate certain surplus lands of American Sumatra, which were no longer required for production, and that the anticipated receipts from the liquidation would greatly exceed the total amount which defendants were offering for the American Sumatra shares (241 F.Supp. at 373).*

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* Plaintiffs' brief is further padded with numerous citations which do not bear upon the issues presented by this appeal, and which accordingly do not call for extended discussion. Thus, e.g., Lebold v. Inland Steel Co., 125 F.2d 369 (7th Cir. 1941), cert. denied, 316 U.S. 675 (Pl. Br. p. 15), and Globe Woolen Co. v. Utica Gas & Electric Co., 224 N.Y. 483 (1918) (Pl. Br. p. 17) involved state law claims, in which Rule 10b-5 was not involved. Dudley v. Southeastern Factor and Finance Corp., 446 F.2d 303 (5th Cir. 1971), cert. denied, 404 U.S. 858 (Pl. Br. p.29) related solely to the question of whether a minority shareholder of a liquidated corporation was a "seller" within the

(Footnote continued next page)

There is no substance in plaintiffs' further contention (Pl. Br. p.25) that the District Court "ignored" the "opinion" of Commissioner Sommer, as reflected in a speech in November, 1974, that Rule 10b-5 should be extended to cover "going private". We know of no authority supporting the view that the informal comments of a single member of a regulatory agency should be treated as authoritative by the courts. The inadvisability of doing so is illustrated in this instance by the fact that Commissioner Sommer himself has apparently modified the views extensively quoted by plaintiffs (New York Times, Section 3, p. 7, July

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Footnote continued from previous page.

the meaning of Rule 10b-5. Bailey v. Meister Brau, Inc., 378 F.Supp. 869 (N.D. Ill. 1973) (Pl. Br. pp. 8, 14) and Dasho v. Susquehanna Corp., 380 F.2d 262 (7th Cir. 1967), cert. denied, 389 U.S. 977 (Pl. Br. pp. 8, 14, 44) held merely that directors who cause a corporation to participate in a securities action, in which such directors have an undisclosed conflict of interest, can thereby violate Rule 10b-5. In Supt. of Insurance v. Bankers Life & Cas. Co., 404 U.S. 6 (1971) (Pl. Br. pp. 8, 10, 14) and Drachman v. Harvey, 453 F.2d 722 (2d Cir. 1971) (Pl. Br. pp. 8, 10, 20) there was no dispute as to the existence of fraud, and the only issue was whether the fraud took place "in connection with" the purchase and sale of securities.

13, 1975):

> "In a telephone interview last week, Commissioner Sommer said that he might be modifying some of his thoughts on going private. 'I might give more credit to the states than I did,' he said. 'And I would have to say it would be harder to persuade a Federal court today than it was three months ago that going private with full disclosure violates Federal securities law.'
>
> "'But I don't feel I'm out on a limb,' he went on, denying a suggestion others have made. 'I feel I highlighted a significant abuse in the capital markets. I suggested there might be an abuse in Federal law <u>though the courts don't seem to see it that way.</u>'"
>
> [Emphasis supplied]

<u>Prior Announcement of The Merger Was Not Required</u>

Faced with the fact that plaintiffs can find no fault with the disclosures actually made -- indeed, they rely on those disclosures in arguing valuation -- plaintiffs are forced to contrive a claim of nondisclosure, based on the fact that the impending merger was not announced prior to being effected. This contention, however, flies directly in the face of the relevant statute, which makes it explicit that advance notice of the impending merger is not required, and that the notice is to be given after, not before, the event. Thus Section 253(d) of the Delaware Corporation Law provides, in

relevant part:

> "In the event all of the stock of a subsidiary Delaware corporation party to a merger effected under this section is not owned by the parent corporation immediately prior to the merger, the surviving corporation shall, *within 10 days after the effective date of the merger*, notify each stockholder of such Delaware corporation that the merger has become effective." [Emphasis supplied]

Accordingly, the Delaware courts have held, following the plain language of the statute, that notice is not required until after the merger is effected. "The only requirement is that the surviving corporation shall notify the stockholder that the certificate of ownership and merger *has been* filed and recorded and the terms and conditions of the merger." *Stauffer* v. *Standard Brands Inc.*, 40 Del. Ch. 202, 178 A.2d 311, 314 (Del. Ch. 1962), *aff'd*, 41 Del. Ch. 7, 187 A.2d 78 (Del. Sup. Ct. 1962) [Emphasis supplied]. The Delaware rule follows logically from the short-form merger procedure established by Section 253 of the Delaware Corporation Law. Under Section 253, it is clear that the holder of more than 90% of the stock of a subsidiary "has the right to pay minority stockholders the value of their shares and thereby eliminate them from continuing participation", and that in the event of disagreement as to the value an appraisal

action is the "exclusive remedy". Stauffer v. Standard Brands Inc., supra, 178 A.2d at 314. Since appraisal is the sole remedy under Section 253, there would be no purpose in requiring mailing of the information statement before adoption of the merger, and accordingly, it is only logical that Delaware law makes no such requirement.* It is untenable to assign as the basis of a claim of fraud a literal compliance with the terms of the applicable Delaware statute.

Since approval of the minority shareholders is not required under Delaware law, and since the information statement was furnished well before the shareholders were obliged to choose between accepting the $150 offered or seeking appraisal, the minority shareholders were not prejudiced in any way by the absence of an advance announcement. The only claim of prejudice made by plaintiffs herein is that the announcement came "too late for state court preventive relief" (Pl. Br. p. 20). This contention,

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* In Levine v. Biddle Sawyer Corp., 383 F.Supp. 618 (S.D.N.Y. 1974) (Pl. Br. pp. 8, 12), the Court made reference to the fact that the short-form merger was not previously disclosed, but it did so only in the context of an alleged continuing scheme to mislead the plaintiffs into delivering the minority shares to the majority group, while not informing plaintiffs of the various other actions which the majority was taking to effectuate its purpose.

however, is without substance. If advance notice had been given, it would have removed one of two interdependent theories on which plaintiffs rely, and they would have been left merely with an injunction suit based on alleged undervaluation. As set forth below (pp. 31-34), the Delaware authorities are clear that no "preventive relief" is available to minority shareholders in these circumstances, and that the proper remedy is an action for appraisal.

It is equally clear, under the federal authorities discussed above, that such an undervaluation claim is insufficient under Rule 10b-5. Plaintiffs thus could not have come close to demonstrating the probability of success on the merits which would be required for a preliminary injunction. See, e.g., Kaufman v. Lawrence, 386 F.Supp. 12 (S.D.N.Y. 1974), aff'd per curiam 514 F.2d 283 (2d Cir. 1975); Missouri Portland Cement Co. v. Cargill, Inc., 498 F.2d 851, 866 (2d Cir. 1974), cert. denied, 419 U.S. 883. See, also, Marshel v. AFW Fabric Corp., F.Supp., [Current] CCH Fed. Sec. L. Rep. ¶ 95,219 (S.D.N.Y. June 24, 1975) (not yet officially reported).

Accordingly, quite apart from the fact that prior notice was not required, it is clear that the absence of such notice made no possible difference.

In effect, plaintiffs here are seeking to eliminate the requirement of deceit or nondisclosure from Rule 10b-5, and to expand the Rule into an omnibus corporate regulation which could be stretched to cover any dispute as to valuation. Nothing in the statute, the Rule, or the voluminous case law thereunder, supports such a result. Indeed, the Supreme Court has but recently reaffirmed the relationship of Rule 10b-5 to "the tort of misrepresentation and deceit". Blue Chip Stamps v. Manor Drug Stores, U.S. , 95 S.Ct. 1917, 1929 (1975). In Blue Chip Stamps, the Court, in reaffirming the purchaser-seller requirement of Birnbaum v. Newport Steel Corp., 193 F.2d 461 (2d Cir. 1952), cert denied, 343 U.S. 956 cautioned more generally against continued, open-ended expansion of the coverage of Rule 10b-5. After noting (p. 1927) that "litigation under Rule 10b-5 presents a danger of vexatiousness different in degree and in kind from that which accompanies litigation in general", the Court went on "to express concern that the inexorable broadening of the class of plaintiff who may sue in this area of the law

will ultimately result in more harm than good" (p. 1931).

We submit that the same considerations are applicable here. To entirely eliminate the requirement of deception or nondisclosure would be to rewrite the Rule, in a drastic and fundamentally unwise manner. Plaintiffs' claim is without foundation under the federal securities laws, and was properly dismissed.

The District Court Correctly Held That Plaintiff Had Not Established the Required Causation

The court below held (92A-93A) that plaintiffs could not meet the requirement of "some causal connection between the wrong done and the harm suffered". Some element of causation -- whether described as "causation in fact", "reliance", or "materiality" -- has repeatedly been recognized as a necessary element of any claim under Rule 10b-5. See, e.g., Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228 (2d Cir. 1974); Chasins v. Smith, Barney & Co., 438 F.2d 1167, 1172 (2d Cir. 1970); Crane Co. v. Westinghouse Air Brake Co., 419 F.2d 787, 797 (2d Cir. 1969), cert. denied, 400 U.S. 822. By refusing to tender their stock, and by first seeking an appraisal, and then bringing the present action, plaintiffs have given the best possible

proof that they were not deceived. Even if there were attempted deception, plaintiffs evidently recognized the alleged deception, and were not caused to act thereon.

Plaintiffs seek to circumvent this difficulty by relying (Pl. Br. pp. 34-35) on the distinction between "loss causation" and "transaction causation" referred to in Schlick v. Penn-Dixie Cement Corp., 507 F.2d 374, 380-1 (2d Cir. 1974), cert. denied, U.S. , 95 S.Ct. 19[illegible]. However, it is clear that the amended complaint herein does not satisfy the requirement of "loss causation" as defined by the court in Schlick: a showing "that the misrepresentations or omissions caused the economic harm" (507 F.2d at p. 380). In the present case, the only "non-disclosure" alleged by plaintiffs is the fact that the Delaware short-form merger was not announced in advance. As set forth above (pp. 23-28), the absence of such an advance announcement did not in any way prejudice plaintiffs, and could not have contributed to their alleged economic harm.

Plaintiffs' reliance (Pl. Br. p. 36) on Vine v. Beneficial Finance Company, 374 F.2d 627 (2d Cir. 1967), cert. denied, 389 U.S. 970, is also misplaced. In Vine, the allegation was that specified misrepresentations had enabled the

defendant to acquire its 90% stock position, which in turn made the short form merger possible. The court in Vine accordingly held that the causation requirement had been met, since "appellant would never be in the position of a forced seller were it not for the fraud" resulting from those misrepresentations (374 F.2d at p. 635).* In the present case, however, Resources acquired its original block of 60% in 1936, and has held more than 95% since 1967 (26A). These acquisitions are in no way challenged here. Under these circumstances, plaintiff cannot claim "that there was deception . . . and that this was in fact the cause of plaintiff's claimed injury", as is required under Rule 10b-5. Vine v. Beneficial Finance Company, supra, 374 F.2d at 635.

The District Court Correctly Held the State Law Claim to be Legally Insufficient.

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* A similar situation was presented in Voege v. American Sumatra Tobacco Corporation, 241 F.Supp. 369 (D. Del. 1965) (Pl. Br. p. 36), where Rule 10b-5 was also applied to fraudulent misrepresentations made in connection with a short-form merger. The court there found (pp. 372-3) that the defendant had acquired its 90% position in the stock of the merged company through a written offer which contained a number of specified "false and misleading" statements. Thus, defendants there had concealed the fact, among other things, that the merged company planned to sell off certain surplus assets which were no longer needed for production, for a price which would exceed the total purchase price of the stock.

The applicable Delaware suthorities establish clearly that no claim for equitable relief is available as to a short-form merger under Delaware law. In this connection, plaintiffs seek (Pl. Br. p. 41) to distinguish Stauffer v. Standard Brands, 40 Del. Ch. 202, 178 A.2d 311 (Del. Ch. 1962), aff'd 41 Del. Ch. 7, 187 A.2d 78 (Del. Sup.Ct. 1962), by urging that in Stauffer "there was only a small spread between the values fixed by the directors and the value claimed by the plaintiff" (Pl. Br. p. 41). However, the holding in Stauffer was not placed on such a narrow ground. In Stauffer, as in the present action, the plaintiff, seeking injunctive relief, alleged "that the price to be paid minority stockholders on the merger so grossly undervalues Planters stock as to constitute a constructive fraud on such stockholders" (178 A.2d at 312). In holding that this complaint failed to state a claim on which relief could be granted, the Vice Chancellor noted (ibid.) that in a dispute as to the value of the shares, or the adequacy of the price offered, the stockholder's proper remedy was an appraisal proceeding under § 262. In affirming, the Supreme Court of Delaware held (187 A.2d at p. 80):

> "The complaint, of course, contains conclusory allegations of oppressive treatment of the minority by the parent corporation, and a prayer that the merger be set aside. But it is plain that the real relief sought is the recovery of

> the monetary value of plaintiff's shares--relief for which the statutory appraisal provisions provided an adequate remedy."
>
> * * *
>
> "The dispute reduces to nothing but a difference of opinion as to value. Indeed it is difficult to imagine a case under the short merger statute in which there could be such actual fraud as would entitle a minority to set aside the merger. This is so because the very purpose of the statute is to provide the parent corporation with a means of eliminating the minority shareholder's interest in the enterprise. Thereafter the former stockholder has only a monetary claim." [Emphasis supplied]

Here, as in Stauffer, "the real relief sought" is simply recovery of what plaintiffs believed to be "the monetary value of plaintiff[s'] shares". This count is simply a claim for appraisal, for which the Delaware Chancery Court is the only proper forum.

Lachman v. Pell, 353 F.Supp. 37 (S.D.N.Y. 1972) (Pl. Br. p. 41) is fully consistent with this position. That case did not relate to a short-form merger under Section 253, and the language which plaintiffs quote was expressly limited to mergers conducted under Sections 251 and 252. Prior to the passage quoted by the plaintiffs, Judge Gurfein cited Stauffer for the proposition that an alleged undervaluation can be "constructively fraudulent" in a Delaware merger "under sections 251

or 252" (353 F.Supp. at 41-2) [Emphasis supplied]. The portion of the Stauffer opinion cited by Judge Gurfein further emphasized that the language in question is not applicable to Section 253 (178 A.2d at 314):

> "However, in a § 253 merger the holder of more than ninety per cent of the outstanding stock of a subsidiary has the right to pay minority stockholders the value of their shares and thereby eliminate them from continuing participation. The only requirement is that the surviving corporation shall notify the stockholder that the certificate of ownership and merger has been filed and recorded and the terms and conditions of the merger. If a stockholder is dissatisfied with the value placed upon his shares he may, failing an agreement upon value, proceed to an appraisal. The dissenting stockholder is thus provided with an adequate and complete remedy. That it is also, under the circumstances presented by the present complaint, an exclusive remedy is evident, for it was obviously the intention of the Legislature that disputes as to the value of shares of minority stockholders should be settled by an appraisal proceeding." [Emphasis supplied]

For the same reason, Popkin v. Bishop, 464 F.2d 714, 720 (Pl. Br. p. 40) does not support plaintiffs' state law claim. Neither that case nor Sterling v. Mayflower Hotel Corp., 33 Del. Ch. 293, 93 A.2d 107 (Del. Ch. 1952), which was cited in Popkin, involved the Delaware short merger statute.

The Delaware authorities are clear that plaintiffs have not stated a legally sufficient claim under

state law, and the complaint should be dismissed in its entirety.

<u>The District Court Correctly Held that Plaintiffs Had No Standing to Maintain a Derivative Action.</u>

The court below held that plaintiffs, no longer being stockholders of Kirby, lacked standing to maintain a derivative action on behalf of Kirby. Citing <u>Vine</u> v. <u>Beneficial Finance Company</u>, 374 F.2d 627, 634 (2d Cir. 1967), <u>cert. denied</u>, 389 U.S. 970 (Pl. Br. p. 7), plaintiffs assert that, by virtue of the merger which gave them the choice of $150 per share or the right to an appraisal proceeding, they are sellers of shares of stock for the purposes of the federal securities laws. However, if they are "sellers" for Rule 10b-5 purposes, see <u>Blue Chip Stamps</u> v. <u>Manor Drug Stores</u>, U.S. , 95 S.Ct. 1917 (1975), they cannot also be considered to have retained their stock for purposes of bringing a derivative action.

None of the cases cited by plaintiffs support their contention that they are entitled to maintain a derivative action after having ceased to be shareholders. In each of the derivative cases cited at Pl. Br. pp. 44-46, the plaintiffs were shareholders of the corporation

involved at the time suit was commenced.* Accordingly, the numerous cases cited by plaintiffs on election of remedies (Pl. Br. pp. 45-46) are inapposite. Plaintiffs cannot "elect" to bring a derivative action, because as non-shareholders they have no standing to do so: Delaware law requires that a derivative plaintiff be a shareholder both at the time of the challenged transaction, and throughout the litigation. See, e.g., Harff v. Kerkorian, 324 A.2d 215, 219 (Del. Ch. 1974); Heit v. Tenneco, Inc., 319 F.Supp. 884 (D. Del. 1970). See, also, Marco v. Bank of New York, 272 F.Supp. 636 (S.D.N.Y. 1967), aff'd on other grounds, 398 F.2d 628 (2d Cir. 1968).

The purported derivative claim is also defective for an even more fundamental reason. As a result of the merger, Kirby is a wholly-owned subsidiary of the Santa Fe defendants who are charged with the alleged violations. Thus any "derivative" recovery, which would inure to the benefit of the alleged wrongdoers, would obviously be meaningless. Under these circumstances,

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* Lichtyger v. Franchard Corp., 18 N.Y. 2d 528 (Pl. Br. p. 46) was not a derivative suit; that case involved claims among the former members of a partnership. In Globe Woolen Co. v. Utica Gas & Elec. Co., 224 N.Y. 483 (Pl. Br. p. 46) the action was maintained by the corporation itself.

the District Court was clearly correct in holding that, even if plaintiffs had the necessary standing, "a derivative recovery would be an inappropriate remedy". 391 F.Supp. at p. 856 (95A), citing Vine v. Beneficial Finance Company, supra, 374 F.2d at 637.

Plaintiffs seek to distinguish Vine on the basis that Kirby is "the surviving corporation". (Pl. Br. pp. 44-45). The purported distinction is without merit. The court in Vine expressly noted that its holding was not based upon the technical issue of which corporation survived, stating that "these problems need not be pursued for we see no reason why Crown and, therefore, its shareholders derivatively may sue, even assuming capacity of the defunct corporation". (374 F.2d at 637). Thus the court in Vine based its decision upon "the meaninglessness of a derivative suit on behalf of Crown - a corporation which has been swallowed whole by the subsidiary of the defendant - wrongdoer" (ibid.). In the present action, the fact that Kirby is wholly-owned by defendant Resources would clearly render any derivative claim equally meaningless. "Delaware law in such a case precludes a shareholder of a merged corporation from suing derivatively once the merger has taken place." Schlick v. Castle, 1974-75 CCH Fed. Sec. L. Rep. ¶ 94,909

(S.D.N.Y., 12/4/74) (not yet officially reported). Accord, Bokat v. Getty Oil Company, 262 A.2d 246 (Del. Sup. Ct. 1970).

Plaintiffs are also incorrect in asserting (Pl. Br. p. 46) that this obstacle could be avoided if a derivative recovery is "suitably allocated if appropriate to avoid benefiting the wrongdoers". Citing Perlman v. Feldmann, 219 F.2d 173 (2d Cir. 1955), cert. denied, 349 U.S. 952. While such a procedure may be available in other jurisdictions, the law of Delaware is clearly to the contrary. As was held by the Delaware Supreme Court in Bokat v. Getty Oil Company, supra, 262 A.2d at 250:

> "Perlman v. Feldman, 219 F.2d 173, 50 A.L.R.2d 1134, cert. denied, 349 U.S. 952, 75 S.Ct. 880, 99 L.Ed. 1277, if it holds that stockholders in a derivative action are entitled to recover in their own right, is not persuasive, for such is not the law of Delaware. Keenan v. Eshleman, supra; Taormina v. Taormina, 32 Del.Ch. 18, 78 A.2d 473."

The purported derivative claim was correctly dismissed by the District Court.

The District Court Correctly Held that Plaintiffs Could Not Validly Invoke Diversity Jurisdiction.

As pointed out by the District Court, complete diversity does not exist among the parties, since as plaintiffs concede (Pl. Br. p. 38) defendant Morgan

Stanley is a citizen of the same state as plaintiffs. Plaintiffs assert, in reply, that Rule 10b-5 furnishes "an independent basis of federal jurisdiction" over the non-diverse defendant, within the meaning of Romero v. International Term. Operat. Co., 388 U.S. 354 (1959). However, since the purported federal claim is insufficient on its face, the diversity claim was properly dismissed.

A similar result has been reached in cases where plaintiffs seek to invoke the doctrine of pendent jurisdiction. It is now settled beyond dispute that where a purported federal claim is dismissed on motion, even though that claim is not held to be "insubstantial" in a jurisdictional sense, the state claims should be dismissed as well. United Mine Workers of America v. Gibbs, 383 U.S. 715, 726 (1966); Kavit v. A. L. Stamm & Co., 491 F.2d 1176 (2d Cir. 1974).

In Kavit, a case arising out of the Texas Gulf mineral strike of 1964, the plaintiff had maintained a brokerage account with defendant Levien, a registered representative with defendant Stamm & Co. The complaint alleged in substance that plaintiff had suffered losses because of short sales in Texas Gulf stock, made in reliance on predictions by defendant Levien that the stock

would fall after its initial rise. Plaintiff joined his state law counts for negligence and conversion with a claim, in the Court's words, "relying on § 10(b) and the ever-present Rule 10b-5" (p. 1181); the Court held, however, that the complaint was "lacking in any sufficient allegations of fraudulent conduct" (p. 1182), and dismissed the federal claim.

In holding that the state claims should be dismissed for lack of pendent jurisdiction, Judge Friendly stated:

> "In the cautionary part of his opinion in Gibbs, 383 U.S. at 726-727, 86 S.Ct. at 1139, which perhaps is not read enough, Mr. Justice Brennan noted that dismissal of common law claims might be merited if '[p]retrial procedures or even the trial itself . . . reveal a substantial hegemony of state law claims.' The Justice added that 'recognition of a federal court's wide latitude to decide ancillary questions of state law does not imply that it must tolerate a litigant's effort to impose upon it what is in effect only a state law case. Once it appears that a state claim constitutes the real body of a case, to which the federal claim is only an appendage, the state claim may fairly be dismissed.' 383 U.S. 727, 86 S.Ct. 1139. If it appears that the federal claims are subject to dismissal under F.R. Civ. P. 12(b)(6) or could be disposed of on a motion for summary judgment under F.R.Civ.P. 56, the court should refrain from exercising pendent jurisdiction absent exceptional circumstances. Indeed, this is essential to avoid a result where, as has been happily said, 'the dog would be wagged by his tail.' Hart & Wechsler, The Federal Courts

> and the Federal System 925 (2d ed. 1973)." [Footnotes omitted] 491 F.2d at 1179-1180.

Similar principles are applicable here. The claim on which plaintiffs rely for their "independent basis of federal jurisdiction" is legally insufficient and the balance of their complaint should be dismissed.

CONCLUSION

For the reasons set forth above, it is submitted that the decision below should be affirmed.

Respectfully submitted,

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Services of three (3) copies of

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of August , 1975

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